

Auditors and the Loan Loss Provisions of Publicly Quoted European Banks

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Introduction

A lack of auditor independence has been blamed for some of the failings in the accounts of European banks during the recent financial crisis (European Commission, 2014)¹. As a consequence, on the 16th April 2014 new rules to improve statutory audits in the EU were adopted by the European Union (European Commission, 2014). The new rules are designed to, *inter alia*, strengthen the independence and professional scepticism of external auditors. Notwithstanding the pressure for regulatory change occasioned by the financial crisis of 2008-2009, there is little, if any, evidence pertaining to the independence of the auditors of European banks from their clients. Commenting on the green paper that preceded the new regulation, Deumes et al. (2010) pointed out that when undertaking regulatory reforms following a crisis, a need to "do something" and political expediency, rather than insights into the true nature of the problems exposed by the crisis, can dominate the proposed

regulatory changes². On the other hand, Campa and Donnelly (2016) report evidence from a sample of UK industrial companies that supports the EU auditing regulations of 2014³. The current article outlines the findings of research, sponsored by CPA Ireland, into the potential reasons why the financial reports of European banks did not meet the needs of users, especially at the onset of the financial crisis.

Empirical Research

We use a sample of 60 individual banks drawn from 14 European countries covering the period 2006-2014. Our sample, which was drawn from countries with both strong and weak banking regulation, comprises 353 firm-year observations. The failure in the financial reports of European banks, in simple terms, is that they had not provided enough for bad loans at the onset of the financial crisis. Thus, the loan loss allowances (LLA) on their balance sheets were understated. To increase their LLA's the banks should have made additional



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1 European Commission, 2014. Regulation 537/2014 of 16 April 2014.

Available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0056>.

2 Deumes, R., Knechel, W. R., Meuwissen, R., Schelleman, C. and Vanstraelen, A., 2010. Response to consultation on EC green paper: Audit policy: Lessons from the crisis. MARC (Maastricht Accounting, Auditing & Information Management Research Centre), Maastricht University.

3 Campa, D., and Donnelly, R. 'Non-Audit Services Provided to Audit Clients, Independence of Mind and Independence in Appearance: Latest Evidence from Large UK Listed Companies' (2016) *Accounting and Business Research*, Vol 46 (4), pp. 422-449.

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provisions against the losses. These additional provisions would have reduced the net income of the bank. The following equation explains the relation between loan loss provisions (LLP's) and LLA's.

$$LLA_t = LLA_{t-1} + LLP_t - NCO_t + Other_t$$

When loans are deemed uncollectable they are charged off against the LLA account. Net loan charge off's (NCO) does not affect income but reduces the LLA. On the other hand, loan loss provisions (LLP's) reduce income and increase the LLA account balance. It is clear from the revised regulations of the EU commission that they believed that a lack of auditor independence was, at least in part, responsible for the under-provisioning of European banks at the onset of the financial crisis.

The most likely reason that the auditor of a bank would find his independence compromised would be through the economic bond he has with his client. Thus, if the auditor was in receipt of unusual or abnormally large fee income, particularly for non-audit services (NAS), his independence may have been compromised. This would make the auditor more indulgent toward a bank that wished to maintain its income at an artificially high level by not providing sufficient LLP's. Thus, finding abnormally high fee income associated with abnormally low provisions would be evidence that auditor independence was compromised.

An alternative explanation for the understatement of LLP's is that the accounting rules that banks and their auditors must obey prevents them from making the requisite provisions. The accounting rules that impacted LLP's at the time of the crisis are to be found in IAS 39. This accounting standard insisted that banks could only recognise "incurred losses". IAS 39 aimed to reduce differences between IFRS and the equivalent FASB standards. In effect, it forbade any anticipation of losses which would allow income smoothing. This was not consistent with the wishes of banking regulators who have a preference for more conservative forward looking provisions. Thus, we also tested for any association between the economic bond with the auditor and delayed provisioning. If provisions are

delayed they will be made when earnings are already low: there will be a negative relation between earnings before provisions (EBP) and provisions. If provisions anticipate future losses they are made when earnings are relatively high: there is a positive relation between earnings and provisions. In a similar vein, pro-cyclical provisioning causes provisions to be negatively related to GDP and counter-cyclical provisioning would mean that provisions are positively related to GDP. In the latter scenario, more provisions are made when times are good, and lending is bullish, in anticipation of future losses.

Since banking is a regulated industry, we also examined the moderating influence of the strength of banking regulation in the country of the bank on both of the above potential explanations for under provisioning. That is, we examine how the strength of banking regulation affects any potential compromise of auditor independence due to abnormally high fees and how it influences the timing of provisions.

Results

We employ abnormal loan loss provisions, particularly abnormal negative (income-increasing) loan loss provisions, as our primary measure of the earnings (audit) quality of banks. We use abnormal fee income, particularly abnormal non-audit service fees (NAS) income and abnormal total fee income as our measures of the economic bond between client and auditor. We report that there is no evidence of abnormal negative (unusually low) loan loss provisions being positively associated with the economic bond. Thus, we find no evidence of impairment of auditor independence in EU banks. This result is maintained for the period that includes the financial crisis as well as the post crisis period.

Further analysis of the loan loss provisions of banks reveals that the provisions are negatively related to EBP and GDP per capita. The latter is an indication that provisioning is very pro-cyclical. The former is consistent with the notion that IAS 39 has compelled banks to make provisions on a so-called incurred loss approach rather than based on anticipated losses. Thus, provisions have been delayed until

their recognition is inevitable and there is absolutely no evidence of income smoothing. We report that increased abnormal fees paid to the auditor are associated with less delay in making provisions (i.e. a better audit) so there is certainly no evidence of a compromise of auditor independence here either. It is also noteworthy that the strength of banking regulation moderates the tendency of banks to delay making provisions as predicted.

We are the first to find evidence of a negative relation between EBP and LLP for European banks. The extant literature has consistently found a positive relation and attributed this to income smoothing. The finding of a negative relation between EBP and LLP is reinforced by the finding of a similar negative relation between LLP and GDP: provisioning is pro-cyclical. We find that this pro-cyclicality is stronger in the period that includes the financial crisis than in the most recent period. Thus, the delayed provisioning by EU banks was most acute in the period of the financial crisis. This is very similar to Laeven and Majnoni's (2003) results for Asian banks during the Asian financial crisis in 1997-98⁴.

Overall, it is clear from our results that delayed provisioning under the incurred loss model as prescribed in IAS 39, rather than any compromise in auditor independence, is the most likely cause of the under-provisioning of European banks particularly during the financial crisis. We also find that stronger banking regulation attenuates any tendency to delay making provisions. This tendency has been mitigated following the crisis. We attribute this to the European Banking Authority ensuring a level of uniformity in banking regulation, at least for the larger EU banks. That said, there remains much variation particularly with respect to disclosure across European banks. With respect to auditors, we find some evidence of spill-over effects with respect to unexpected fees for banks primarily operating in countries where banking regulation is traditionally strong.

4 Laeven, L. and Majnoni, G., 2003. Loan loss provisioning and economic slowdowns: too much, too late? *Journal of Financial Intermediation*, 12 (2), 178-197.